CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

June 26, 2006

Flood Insurance Reform and Modernization Act of 2006

As ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs on May 25, 2006

SUMMARY

The Flood Insurance Reform and Modernization Act of 2006 would provide the National Flood Insurance Program (NFIP) with funds to pay remaining valid claims from the 2005 Gulf Coast hurricanes and reform the program, which is currently in an unsustainable financial position. Without a change in law, the NFIP will be unable to pay all flood insurance claims promptly, and faced with a nonfunctional program, those policyholders who are not required to carry flood insurance may abandon it. CBO cannot predict when this might occur, but today the program faces a future with inadequate resources to pay its obligations.

CBO expects that enacting the Flood Insurance Reform and Modernization Act of 2006 would improve the financial status of the NFIP and significantly increase the likelihood that the program could continue to offer insurance coverage and pay claims in a timely fashion. By providing funds to pay remaining claims from the 2005 Gulf Coast hurricanes and forgiving the debt incurred to pay previous claims from 2005, the bill would essentially return the NFIP to a financial condition similar to that which existed before Hurricane Katrina.

Enacting the bill would also strengthen the NFIP's financial position in the future. It would direct the Federal Emergency Management Agency (FEMA) to impose rate increases of up to 15 percent per year on all policyholders so as to establish a reserve fund for the insurance program. That reserve fund would be available to pay insurance claims whenever it was needed. The bill also would require some policyholders that do not pay the full cost of their insurance coverage to gradually begin to do so. Finally, it would require some policyholders to carry a larger deductible amount on their insurance policies, and it would end the current practice of offering new policies to some property owners at less than their expected cost. These requirements would increase the cost to policyholders and reduce the net cost of the program to the government. Over the next several years, those changes would improve the chances that the NFIP would have sufficient funds to pay future claims.

CBO estimates that enacting the bill would reduce net outlays of the flood insurance program over the next 10 years by about $7.6 billion relative to current law. Changes in the NFIP (mostly higher premiums) and the elimination of its Treasury debt would reduce the program's net outlays by about $19 billion over that period. But the appropriation of funds to pay the remaining claims from the 2005 hurricanes and the increased availability of funds to pay future claims that could not be paid under current law would add over $12 billion to the program's outlays. At the same time, because the bill would forgive the NFIP's debt to the Treasury, that agency would forgo interest payments from FEMA of about $9.5 billion over the 2007-2016 period, CBO estimates. The net impact of the bill—including its effect on the NFIP and on Treasury's interest receipts—would be an increase in direct spending of $1.9 billion over the 2007-2016 period.

As the value of flood insurance coverage in force continues to grow, the cost of claims that the NFIP may face in the next decade will also increase. In most years, they will probably total between $1 billion and $5 billion—similar to the losses the insurance program experienced in the years before Katrina—but there could be another catastrophic flood in the next decade with much larger losses. CBO's estimate assumes that annual flood insurance claims during this period are equal to the amounts anticipated by the program's actuaries for a typical year, but actual claims are likely to vary substantially from year to year and the total amount of claims over the next 10 years is quite uncertain. This estimate also assumes that substantial numbers of policyholders drop flood insurance coverage or find alternatives to the NFIP as their premiums rise steadily over the period.

The bill also would increase the amounts authorized to be appropriated for FEMA's flood mapping program. In addition, the bill would require FEMA to participate in state-sponsored claims mediation programs and would direct the Government Accountability Office (GAO) to conduct multiple studies. Assuming appropriation of the authorized amounts, CBO estimates that implementing these provisions would cost $1.5 billion over the 2007-2011 period and an additional $900 million after 2011.

The bill contains two intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA) because it would direct state regulatory agencies to require, and state lenders to provide, information on flood risk to more mortgage borrowers. CBO estimates that the cost for state governments to comply with those mandates would be small and well below the annual threshold established by UMRA ($64 million in 2006, adjusted annually for inflation). The legislation also would impose private-sector mandates, as defined in UMRA, on certain mortgage lenders. Based on information from industry and government sources, CBO expects that the direct costs to comply with those mandates would fall below the annual threshold for private-sector mandates established in UMRA ($128 million in 2006, adjusted annually for inflation).

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of the bill is shown in the following table. The budgetary impact of this legislation falls within budget function 450 (community and regional development).

	By Fiscal Year, in Millions of Dollars									
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
CHANGES IN DIRECT SPENDING [a]										
Payment of Remaining 2005 Claims										
Estimated Budget Authority	2,400	0	0	0	0	0	0	0	0	0
Estimated Outlays	1,825	375	200	0	0	0	0	0	0	0
Reforms to the NFIP										
Estimated Budget Authority	900	600	250	0	0	0	0	0	0	0
Estimated Outlays	900	600	250	-150	-650	-1,150	-1,775	-2,250	-2,700	-3,125
Forgone Treasury Interest Receipts										
Estimated Budget Authority	875	875	925	975	975	975	975	975	975	975
Estimated Outlays	875	875	925	975	975	975	975	975	975	975
Total Changes										
Estimated Budget Authority	4,175	1,475	1,175	975	975	975	975	975	975	975
Estimated Outlays	3,600	1,850	1,375	825	325	-175	-800	-1,275	-1,725	-2,150
CHANGES IN SPENDING SUBJECT TO APPROPRIATION										
Flood Mapping and Studies										
Estimated Authorization Level	401	400	400	400	400	400	0	0	0	0
Estimated Outlays	101	260	340	400	400	400	300	140	60	0

a. In addition, CBO estimates that revenues would increase by about $1 million a year over the 2007-2016 period.

BASIS OF ESTIMATE

For this estimate, CBO assumes that the bill will be enacted near the beginning of fiscal year 2007 and that the authorized amounts will be appropriated for each fiscal year.

Direct Spending and Revenues

Over the 2007-2016 period, CBO estimates that enacting the legislation would reduce net outlays for the flood insurance program by about $7.6 billion and would increase the Treasury's net outlays for interest by about $9.5 billion.

Funding for Claims from the 2005 Gulf Coast Hurricanes. Section 10 would appropriate such sums as are necessary to pay the remaining claims from the 2005 Gulf Coast hurricanes that exceed the program's resources. According to FEMA, the total claims for those hurricanes will be about $23.1 billion. The NFIP has already been authorized to borrow $20.8 billion for that purpose. Based on information from FEMA, CBO estimates that enacting this bill would provide another $2.4 billion for paying claims from the 2005 hurricanes and that the resulting outlays would occur over the 2007-2009 period.

Reforms to the NFIP. The bill contains several provisions that together would govern the magnitude of future rate increases for flood insurance and reduce the amount of expected future claims. Those provisions would:

- Require the NFIP to create a reserve fund;
- Increase the ceiling on average annual rate increases that can be imposed on policyholders from 10 percent a year to 15 percent a year;
- Forgive the program's current outstanding debt to the Treasury;
- Phase out subsidized premiums for some policyholders;
- Raise the deductibles for certain types of policyholders; and
- Prohibit FEMA from issuing new subsidized insurance policies.

CBO estimates that these changes would reduce net outlays of the NFIP by about $10 billion over the 2007-2016 period. The program's net outlays would decline, relative to current law, because premium increases would be greater and no interest would have to be paid to the Treasury on the NFIP's current debt (which would be forgiven). That decline would be partially offset by higher claims payments because, under the bill, the NFIP would have sufficient funds to pay average expected claims; under current law, it would not.

Establish a Reserve Fund and Increase the Limit on Annual Rate Increases. FEMA would be required to establish a reserve fund equal to 1 percent of the value of flood insurance coverage in force in the previous year. By the end of 2006, FEMA expects that the value of flood insurance coverage in force will be about $1 trillion; by 2015, the amount of coverage is likely to reach $1.5 trillion. The bill would direct FEMA to gradually accumulate the necessary reserves over 10 years.

In addition, section 4 would authorize the NFIP to increase rates on policies within each risk category by an average of up to 15 percent per year. Under current law, the limit on rate increases is 10 percent. CBO expects that FEMA would have to impose annual 10 percent rate increases on flood insurance policies under current law in order to pay claims and service its outstanding debt to the Treasury. Under the bill, however, CBO expects FEMA would need to increase most rates by 15 percent annually in order to pay claims and accumulate the required reserves. CBO interprets this legislation as directing FEMA to implement rate increases to meet the funding targets for the reserve fund even if those rates exceed the estimated actuarial cost of providing flood insurance.

For this estimate, we assume that FEMA could begin to implement premium increases to establish a reserve fund starting in May 2007, and that it would take one year before any increase was fully implemented because individual flood insurance policies are renewed throughout the year. Starting in May 2007, the bill would direct FEMA to collect 10 percent of the reserve fund requirement (or about $1 billion) in 2007. That directive would imply a very large rate increase; however, under the bill, the increase would be capped at 15 percent. If claims over the next several years occur at the actuarial average, a significant portion of the increased premium collections would be needed to pay flood claims and would not be available to accumulate in a reserve fund for at least a few years.

For this cost estimate, CBO assumes that FEMA would impose 15 percent rate increases on its policyholders each year over the 2007-2016 period in an attempt to reach the reserve amounts specified in the bill, but that it probably would fall short of that target in this period. CBO estimates that flood insurance coverage in force would grow from about $1 trillion today to around $1.5 trillion by 2015. It is unlikely that FEMA would be able to collect enough premiums above amounts it pays for claims over the next 10 years to fully capitalize a reserve fund equivalent to 1 percent of insurance coverage in force. CBO estimates that, with all of the program changes authorized by the bill, the NFIP would have a reserve fund with a balance of about $10 billion in 2016, less than the estimated target of about $15 billion for that year. (If losses due to floods are less than average over that period, the balance would be greater. If losses exceed the average, the balance would be smaller. Based on FEMA's actuarial review of the NFIP, CBO estimates the expected loss is about $3.5 billion for policies in force in 2006.)

To estimate the amounts that could be collected in response to the bill's reserve fund requirement, CBO reduced the projected amount of flood insurance coverage to reflect the likelihood that some policyholders would drop NFIP coverage or find alternatives to that coverage after successive years of 15 percent annual rate increases ultimately quadrupled their insurance premiums. Policyholders that live in lower-risk areas that are paying actuarially fair insurance premiums today might seek and find alternative insurance products in the future if their cost to participate in the NFIP far exceeded their actuarial risk. Alternatively, some policyholders in this situation might choose to reduce their flood coverage or drop it altogether. Such resources would reduce the total coverage in force and hence the required size of the reserve fund.

Increase Rates for Pre-FIRM Properties. Section 4 would authorize the NFIP to gradually increase premiums on certain properties that were built before flood insurance rate maps (FIRMs) were completed or before 1975, whichever is later—known collectively as pre-FIRM properties. The affected pre-FIRM properties include:

- Properties that have been flooded four or more times with the total claims payments exceeding $20,000; or properties with two or more claims exceeding the fair market value of the property;

- Nonresidential structures;

- Nonprimary residences (such as vacation homes);

- Properties that sustain damage exceeding 50 percent of the fair market value of the property after enactment of the bill; and

- Properties that undergo improvements or renovations exceeding 30 percent of the fair market value of the property after enactment of the bill.

Under current law and policies, many pre-FIRM structures are charged a flood insurance premium that is less than the full actuarial cost of the insurance. Thus, such policies are considered to be subsidized by the program. The bill would authorize FEMA to increase rates on those specified types of pre-FIRM properties (but not other types of pre-FIRM properties) by 25 percent a year until the actuarial rate is achieved. At that rate, CBO expects that many, but not all, of these pre-FIRM properties would start paying actuarial rates within the next 10 years.

According to FEMA, approximately 455,000 pre-FIRM properties would be affected by the bill, and the average premium for those properties is about $800 a year. CBO expects that owners of some of those properties would either drop flood insurance coverage or reduce their level of coverage in response to an increase in premium charges.

Raise Deductible for Pre-FIRM Properties. Section 12 would increase the deductible for pre-FIRM properties from $1,000 to $2,000 for both the structure and its contents. For pre-FIRM properties, which do not pay actuarial rates for their insurance, the increase in the deductible would not affect the price of the insurance, but it would decrease the amount of claims payments made for such properties. Based on information from FEMA, CBO estimates that claims payments would decrease by about 7.5 percent if this higher deductible were implemented.

Bar New Subsidized Policies for Pre-FIRM Properties. Section 4 would prohibit FEMA from offering new subsidized insurance policies. CBO estimates that this provision would reduce spending by a negligible amount over the next 10 years because we expect few new properties eligible for pre-FIRM rates to be added to the flood insurance program.

Forgone Treasury Interest Payments. Section 11 would relieve the NFIP of its obligation to repay funds borrowed to pay claims from the 2005 Gulf Coast hurricanes. Current law requires FEMA to repay any borrowed funds (with interest) as it collects premiums. In the absence of legislation to relieve FEMA of it obligation to repay debt, FEMA would need to use a portion of its premium income to pay debt-service costs to the Treasury. Under this bill, such payments would not be necessary, and income that the NFIP would otherwise use to service its debt would instead be used to pay policyholders' claims and accumulate reserves.

Interest payments from the NFIP to the Treasury are intragovernmental transactions; they are recorded in the budget as outlays for FEMA and as offsetting receipts (that is, negative outlays) for the Treasury. Eliminating those payments would reduce FEMA's outlays (making more funds available to pay claims and accumulate reserves)—but it also would increase the Treasury Department's net outlays by $0.9 billion to $1.0 billion per year because it would be receiving less interest income.

Additional Claims Payments Under the Bill. CBO expects that enacting this legislation would enable the flood insurance program to continue to grow in size and to pay claims that it would be unable to pay in a timely fashion under current law. That would be possible because the legislation would appropriate $2.4 billion needed to pay remaining NFIP claims from 2005, increase premiums and deductibles, and eliminate the program's debt to the Treasury. Over the 2007-2016 period, CBO estimates that NFIP would pay over $12 billion for current and future claims that probably could not be compensated under current law. That estimate assumes that flood insurance claims would be equivalent to the expected annual cost of the program as estimated by FEMA's actuaries—over $3.5 billion today. In future years, those expected losses will increase with inflation and change as the number of policies in force varies.

Other NFIP Modifications. The bill would make certain changes to the NFIP that might increase the number of policies in the program and result in the program collecting more premium income than it currently does. CBO has no information to estimate the number of policies that could be added to the program from enacting these sections.

Mandatory Coverage Areas. Section 5 would require that homes located behind levees, dams, and other man-made structures become part of special flood hazard areas, which are areas at high risk for flooding. The bill would require property owners to purchase flood insurance once the NFIP updates its flood maps to include those new high-risk areas. CBO assumes that the additional policies generated by this new mandatory purchase requirement would be priced initially at actuarial rates. CBO has no basis for estimating the number of policies that might be sold under this provision.

Nonmandatory Participation for the 500-year Floodplain. Section 19 would require the NFIP and regulated lending institutions to notify communities if they are entirely or partially located within the 500-year floodplain. Properties within the 500-year floodplain would not be subject to mandatory purchase requirements but could voluntarily purchase flood insurance, which CBO assumes would initially be priced at actuarial rates. As the cost of those policies increased far above actuarial rates to capitalize the proposed reserve fund, CBO expects few of these property owners would elect to buy flood insurance.

Civil Penalties. Section 8 would increase the civil penalty from $350 to $2,000 for lenders that do not enforce the mandatory purchase requirement. CBO estimates that the increased revenue from the civil penalties established under this bill would amount to about $1 million a year.

Spending Subject to Appropriation

The bill also would authorize additional discretionary spending. Assuming appropriation of the authorized amounts, CBO estimates that such spending would total about $1.5 billion over the 2007-2011 period and an additional $900 million after that period.

Flood Mapping Program. Section 17 would authorize the appropriation of $400 million a year over the 2007-2012 period for updating flood maps to include the 500-year floodplain and areas that would be flooded if a dam or levee failed. In addition, the bill would reestablish the Technical Mapping Advisory Council to assist with managing flood mapping activities. Based on historical spending rates for this program, CBO estimates that implementing this section would cost $1.5 billion over the 2007-2011 period and an additional $900 million in subsequent years.

Participation in Claims Mediation. Section 22 would require FEMA to participate in state-sponsored claims mediation programs to help expedite the settlement of disputed flood insurance claims. The additional administrative costs of this provision are uncertain because FEMA does not know how it would implement this provision. If staffing increases were significant, however, it is likely that the NFIP would raise the administrative fees assessed on policyholders and that added income from those fees would offset any increase in costs.

Studies. Section 24 would direct GAO to conduct four studies on various aspects of the NFIP as well as an audit of the program's spending related to the 2005 Gulf Coast hurricanes. CBO estimates that conducting those studies would cost about $1 million over the 2007-2011 period.

IMPACT ON STATE, LOCAL, AND TRIBAL GOVERNMENTS

The bill contains two intergovernmental mandates as defined in UMRA. It would require state agencies that regulate mortgage lenders to require that those lenders provide borrowers with information about flood insurance if the property covered by the mortgage is located in the 500-year floodplain. It also would require state agencies that offer direct mortgages to provide such information. Based on information from mortgage lenders, state regulatory agencies, and state housing authorities, CBO estimates that the cost for state regulatory agencies would be minimal and the number of loans for which state agencies would be required to provide flood information would be small. The total cost for state agencies to comply with those requirements would be well below the annual threshold established in UMRA ($64 million in 2006, adjusted annually for inflation).

IMPACT ON THE PRIVATE SECTOR

The legislation would impose private-sector mandates, as defined in UMRA, on certain mortgage lenders. Based on information from industry and government sources, CBO expects that the direct costs to comply with those mandates would fall below the annual threshold for private-sector mandates established in UMRA ($128 million in 2006, adjusted annually for inflation).

The bill would require mortgage lenders—when making, increasing, extending, or renewing any loan secured by property located in an area within the 500-year floodplain—to notify the purchaser or lessee and the servicer of the loan that such property is located in the 500-year floodplain. The bill also would require certain mortgage lenders to notify policyholders that insurance coverage may cease with the final mortgage payment and to provide direction as to how the homeowner could continue flood insurance coverage after the life of the loan. In addition, certain mortgage lenders would be required to deposit premiums and fees for flood insurance in an escrow account on behalf of the borrower. According to industry representatives, the cost for mortgage lenders to provide the additional notices and direction and to escrow flood insurance payments would be small. Therefore, CBO estimates that the aggregate direct cost of complying with the mandates would fall below the annual threshold.

PREVIOUS CBO ESTIMATE

On April 4, 2006, CBO transmitted an estimate for H.R. 4973, the Flood Insurance Reform and Modernization Act of 2006, as ordered reported by the House Committee on Financial Services on March 16, 2006.

H.R. 4973 contains a number of provisions similar to those in this bill, such as increasing rates on certain pre-FIRM properties, increasing the annual limit on rate increases, and providing funds to pay the remaining claims from the 2005 Gulf Coast hurricanes. H.R. 4973 would not, however, forgive the NFIP's debt to the Treasury, and CBO estimated that all of the additional premium income under the bill would have to be used to pay claims. The cost estimates reflect those differences between the bills.

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